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SUBJECT: Argentina: World Bank Country Director Cautions on Economy

Ref: (A) Buenos Aires 1703
(B) Buenos Aires 1696
(C) Buenos Aires 1685
(D) Buenos Aires 1682

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Summary

¶1. (SBU) The local World Bank (WB) Country Director (protect) sees the GoA "walking a tightrope" in terms of its capacity to maintain market confidence, stem capital flight, and sustain twin fiscal and current account surpluses in a context of economic slowdown, continued high rates of GoA public infrastructure spending, high inflation, and lower commodity prices. While GoA authorities have responded to constraints in accessing international financial markets by buying back debt, announcing their intention to pay down Paris Club debt and by re-opening talks with holdout creditors, the impact of these efforts on market confidence has been limited by investor concern on macroeconomic policy drift and by heavy GoA spending in the run-up to 2009 mid term elections.

¶2. (SBU) WB Country Director Pedro Alba told Ambassador December 12 he had personally cautioned Chief of Cabinet Sergio Massa on Argentina's precarious condition. He advised Massa on the need to build confidence by announcing -- and following -- a hard fiscal rule to maintain the primary fiscal surplus; cleaning up GoA statistics agency INDEC; and addressing concerns on how the GoA will manage nationalized pension fund resources and equity holdings. Should capital flight overwhelm the GoA's ability to sustain confidence in the currency, the WB has developed a contingency crisis plan that would allocate additional Bank resources to social safety net programs. Any restructuring of the roughly US$5 billion in Bank exposure would only come in the context of an IMF program. Alba estimated that, in a crisis scenario, the GoA would need some $30 - $35 billion, including to rebuild reserve levels. End Summary.

GoA Walking a Capital Flight Tightrope

¶3. (SBU) In a December 12 meeting with Ambassador, World Bank (WB) Country Director Pedro Alba briefed the Embassy on the Bank's country assistance strategy (Ref A) and on its views on GoA economic management. Alba's main concern was that the GoA is "walking a tightrope" in terms of its capacity to maintain market confidence and stem capital flight. While there are sufficient local currency funds available to the GoA to cover 2009 debt obligations, Alba said, the question is whether Argentina will be able to attract and retain sufficient dollar reserves. Roughly US$16 billion of capital

left Argentina's financial system in the first three quarters of 2008 and, if another US$ 8-12 billion of Argentine capital flees, the GoA will be "all alone - out on a limb" in terms of its ability to sustain needed hard-currency reserve levels. Comment: Former Economy Minister Roberto Lavagna also flagged the implications of capital flight to Ambassador and Econ Counselor (Ref B). End Comment.

¶4. (SBU) Alba said he had personally cautioned Chief of Cabinet Sergio Massa on Argentina's precarious condition, but that Massa had argued that Argentina will muddle through 2009/10. Alba said he advised Masa that important confidence-building measures are needed and could include: (1) cleaning up GoA statistics agency INDEC; (2) announcing and following a hard fiscal rule to maintain the primary fiscal surplus; and (3) setting out clear and monitorable guidelines on how recently nationalized private pension fund (AFJP) resources will be managed and, as importantly, how the GoA will manage the board seats on a broad range or Argentine and foreign companies that it inherited as a consequence of the private pension fund nationalization exercise. Whether and how GoA-appointed company directors will vote GoA shares needs to be clarified as soon as possible to regain investor confidence, Alba said.

World Bank's Crisis Contingency Planning

¶5. (SBU) Alba joked that he'd congratulated Massa on the GoA's impressive ability to keep generating economic and economic policy surprises. He told Ambassador that, should capital flight overwhelm the GoA's ability to sustain confidence in the currency, the WB has developed a contingency crisis plan that would allocate additional Bank resources to social safety net programs. Any restructuring of the roughly US$5 billion in Bank exposure, however, would only come in the context of an IMF program. Alba estimated that, in a crisis scenario, the GoA would need some $30 - $35 billion, including to rebuild reserve levels.

International Crisis Impact on Argentina

¶6. (SBU) Alba expanded on World Bank views on the Argentine economy in a subsequent discussion with EconCouns. Alba summarized the short-term impact of the financial crisis:

-- An uncertain domestic policy environment that has eroded market confidence has led to a decline in domestic credit and a linked buildup of liquidity cushions by private local banks. Alba noted significant deposit outflows and sharp increases in interest rates and demand for U.S. dollars following the announcement of the nationalization of pension funds in October.

-- Capital outflows are complicating monetary management. Following third quarter 2008 capital outflows of roughly US$6 billion (and roughly US$16 billion for the first three quarters of 2008), stability is gradually returning to domestic capital markets following significant late November and early December intervention by the central bank and GoA regulatory agencies.

-- As gross international reserves have declined, the GoA has moved to shelter the economy from further financial shocks. In response to increased financial volatility, the central bank has intervened frequently in foreign exchange markets to preserve currency stability. As a result, gross international reserves have declined from over $50 billion in early 2008 to about $45 billion (nine months of imports). However, net international reserves (net of central bank obligations with the BIS and other international financial institutions) are down to roughly $35 billion.

-- The exchange rate will continue to depreciate gradually following the sharp 7.8% depreciation in October. According to Alba, the GoA's primary monetary policy objective is to preserve exchange rate stability and confidence in the currency. In light of increased financial volatility, the central bank will continue to allow the exchange rate to depreciate in an orderly and gradual manner. In addition to intervening in foreign exchange markets, the central bank has also tightened capital controls. Comment: Central Bank

President Redrado confirmed these points to Ambassador December 17, adding that the key in his view is managing an orderly depreciation without panic in the markets. End Comment

-- The value of Argentine financial assets has been hurt by increased global risk aversion and eroded market confidence. Bond and stock prices have fallen sharply since mid-2008, with equity values down almost 50% year to date. Argentine equity values have been particularly hard hit as market confidence has been shaken by the farm crisis and more recently by the GoA takeover of private pension funds.

-- Argentine country risk premiums remain among the highest and most volatile in the Latin America. Argentine EMBI and credit default swap spreads have been in a constant upward trend throughout 2008, with EMBI spreads peaking at 1965 basis points on November 14, an increase of roughly 1,290 bps since August 2008. Argentine EMBI spreads are currently around 1,900 basis points, second only to Ecuador and among the most volatile in the region.

Medium Term Economic Outlook

¶7. (SBU) Alba was concerned that the GoA has yet to implement an adequate mix of monetary and fiscal policies that would allow it to address inflationary pressures and report credible inflation figures. It will be increasingly difficult to sustain twin fiscal and current account surpluses in a context of economic slowdown, continued high rates of GoA public infrastructure spending, high inflation, and lower commodity prices. While Alba believes the primary fiscal surplus should hold at 3.4% for calendar 2008, even with real GDP growth decelerating to the 6% range by the end of 2008, fiscal accounts will remain vulnerable to lower commodity prices, declining growth, and GoA expenditure rigidities. The WB is projecting GDP growth in 2009 at the 2.5% level. The Bank is particularly concerned at the fiscal situation in many provinces that remain highly dependent on the federal government for resource transfers.

¶8. (SBU) Argentina's current account surplus is falling and Alba expects it to end 2008 at about 1.8% of GDP (compared to the Central Bank's consensus estimate of 2.2%). Any further decrease in commodity prices coupled with a decrease in global demand will further reduce Argentine exports, and Alba predicted that the current account is likely to shift into deficit in 2009. He said that, if this happens, it will set off alarms in Argentina and internationally. With a capital account deficit also likely in 2008 and 2009, there will be further declines in international reserves. (Comment: Estimating the direction of the balance of payments is difficult, given that a significant depreciation of the peso -- which appears likely -- would result in stronger exports and increasing reserves, along with increasing capital outflows, with the net effect uncertain.)

¶9. (SBU) Alba's principal concern is that an increasingly unfavorable external environment, coupled with uncertainty over the course of GoA macro policies, will continue to depress market confidence. On the positive side, GoA authorities have responded to constraints in accessing international financial markets by buying back debt and announcing their intention to pay down Paris Club debt and re-open talks with holdout creditors. These announcements have been interpreted by markets as signs of the GoA's willingness to pay. But their impact on market confidence has been limited by investor concern on policy drift and the GoA's unabashed determination to use funds to shore up its electoral prospects in the 2009 mid-term elections. The GoA could better manage the situation, Alba said, by improving the credibility of inflation figures and by putting together a stronger and more predictable program to maintain the primary fiscal surplus.

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